

THE ECONOMIC SITUATION

A Quarterly Commentary on the Economy

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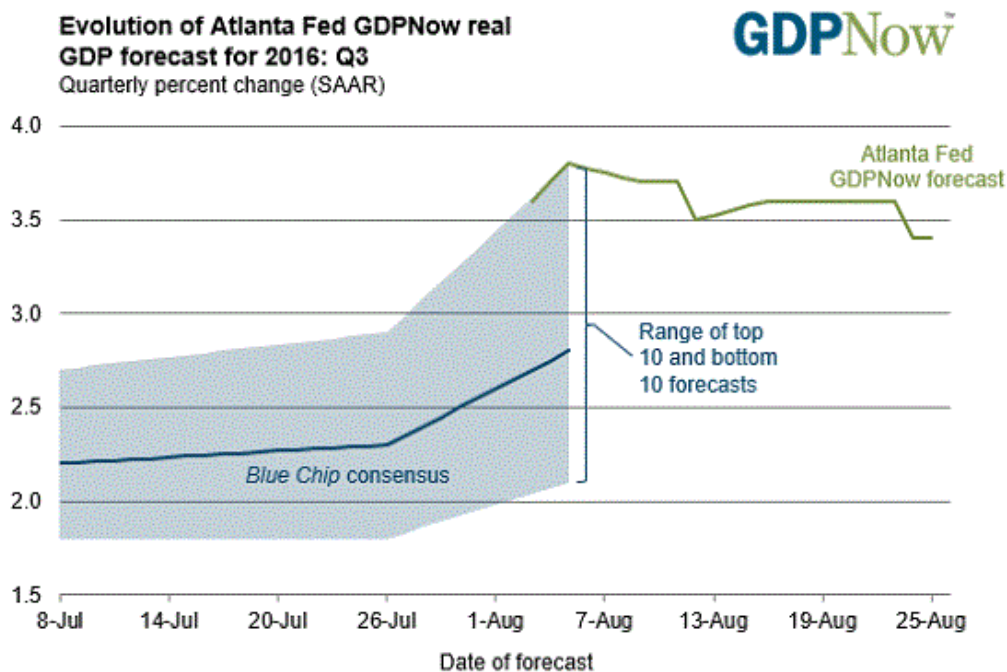
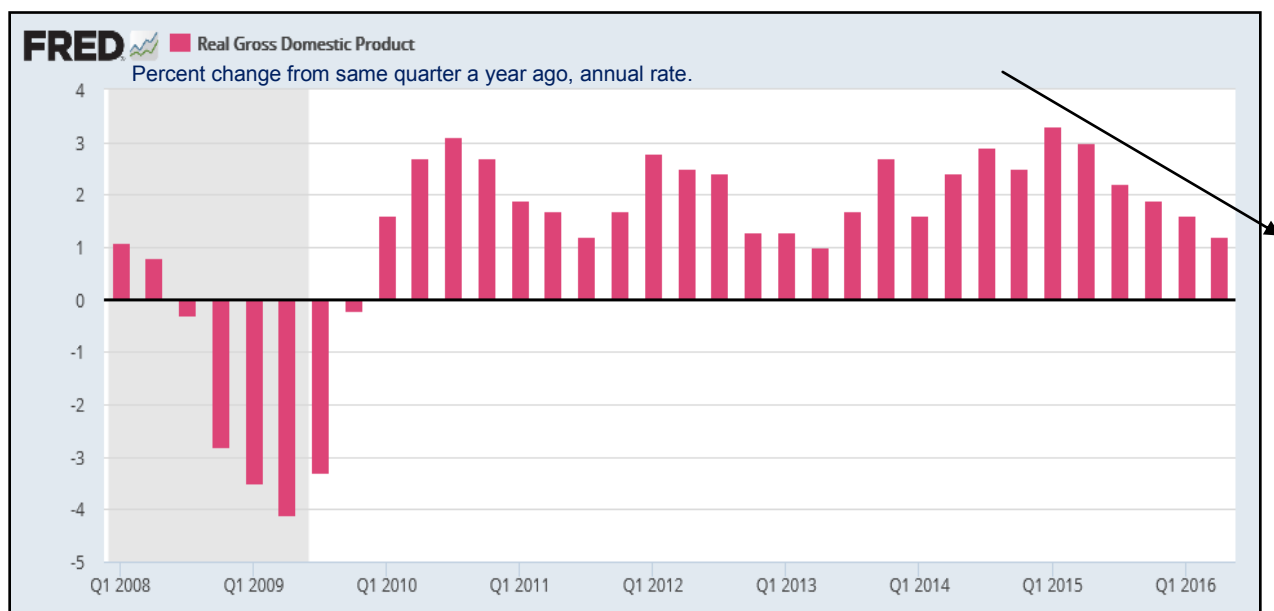
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The U.S. Economy: Still in Low Gear

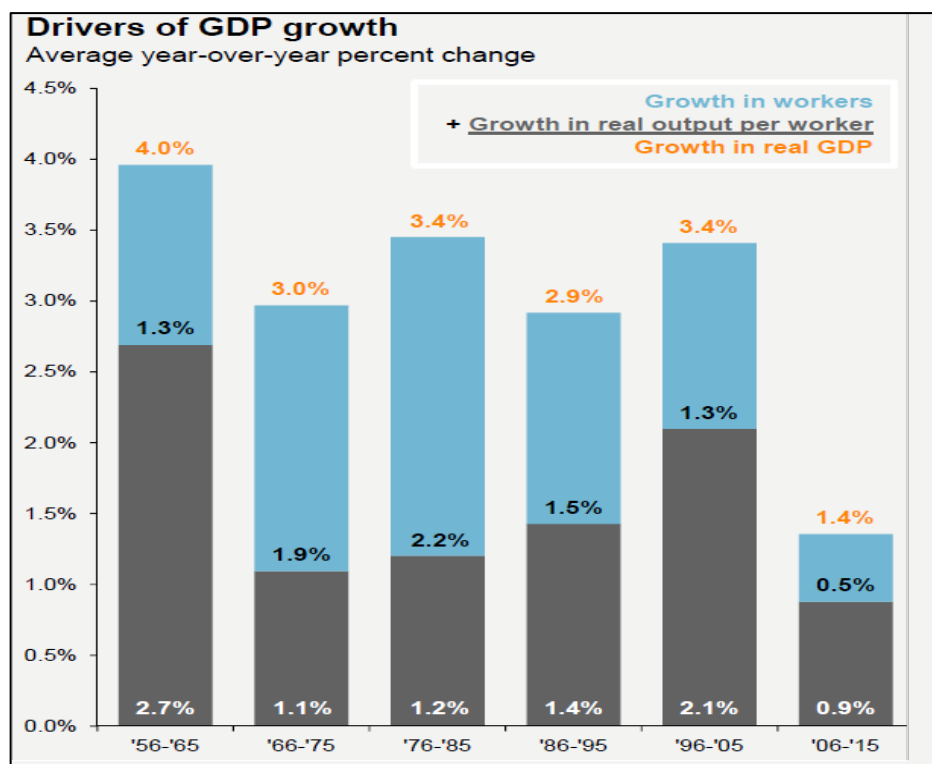
Europe has a bad case of the slows. Mexico's economy has hit the skids. The UK post-Brexit economy is still trying to get up on its legs. And in the United States, the consumer is keeping the merry-go-round spinning. While some politicians claim all is well in the homeland and others say everything is either rigged or falling apart, the truth seems to lie somewhere in between. As September rolls around, the US autumn economy is chugging along, but at a pitifully slow rate.

The latest GDP reckoning from the Department of Commerce tells the tale, at least for now. The latest estimate for second quarter growth was 1.1%, which followed first quarter's 0.8%, giving an average of less than 1.0% for the year's first half. The accompanying chart produced using the St. Louis Fed's data shows the south-bound trend continues. At this pace, we will be lucky to see the year close out with 1.4% growth. In order to hit that target, the last six months will have to be a lot better. And that is what the Atlanta Fed's GDPNow promises. For now, their

August 26 estimate for 3Q2016 calls for 3.4%. However, the longer-term prospects are not all that bright.



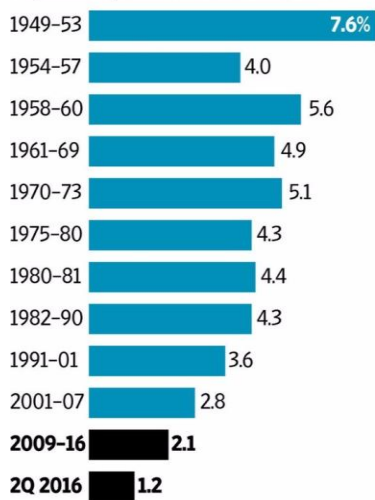
An analysis by Century Wealth Management looks at fundamental GDP growth drivers and explains why we should not expect to see rockets launching in the next year or so.



Remember, growth improvements depend on two things: More people working smart or the same people working smarter. As indicated here, slow growth in the work-age population coupled with weak gains in labor productivity darken the prospects for hitting the GDP high road. When we look at the post-2008 GDP growth observations, we see one of the palest recession recoveries in modern times. As shown here in the *Wall Street Journal* analysis, in 2Q2016 it was consumer action powering the GDP merry-go-round.

Underwhelming Growth

Average GDP growth during each expansion, at an annualized rate



Note: Figures are adjusted for inflation and seasonality
Source: Commerce Department

Notable contributions to Q2 growth

CONSUMER SPENDING

+2.83 pct. pts.

NET TRADE

+0.23 pct. pts.

GOVERNMENT SPENDING

-0.16 pct. pts.

RESIDENTIAL INVESTMENT

-0.24 pct. pts.

BUSINESS INVESTMENT

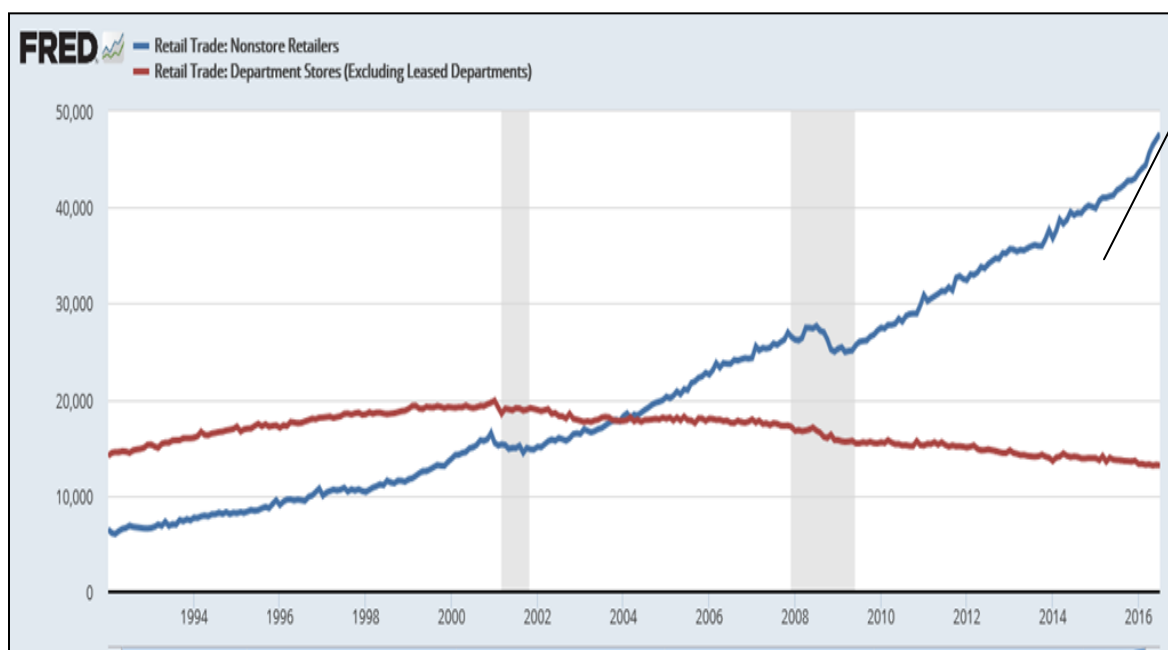
-0.28 pct. pts.

CHG. IN PRIVATE INVENTORIES

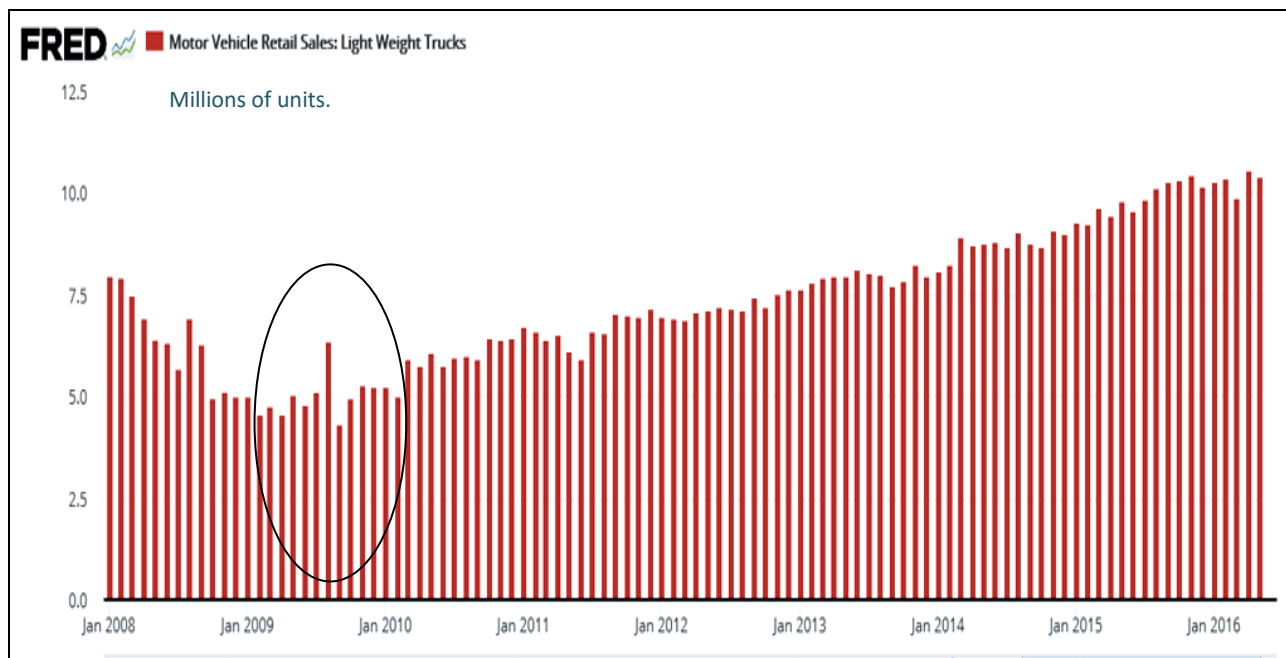
-1.16 pct. pts.

THE WALL STREET JOURNAL.

And as the next Federal Reserve Economic Data (FRED) chart tells us, most of the spending is being done on-line in non-store sales. Notice that on-line retail sales began to beat out department store sales in 2004. Meanwhile, the trend has accelerated. But get an eye full of the last four or five observations in the chart. On-line activity has lit the afterburner.



While on-line sales are skyrocketing, sales of light trucks, which include SUVs, shown in the next chart are finally reaching a plateau, and a high one at that.



I call attention to the tall 2008 observation that resulted from the federal Cash-for-Clunkers program. That program began in July 2008 and ended in December 2008. In an effort to assist the troubled auto industry and encourage the purchase of more fuel efficient cars, Congress appropriated \$1 billion for the program. So many consumers scrambled to get on board that Congress had to find another \$2 billion to keep the program going.

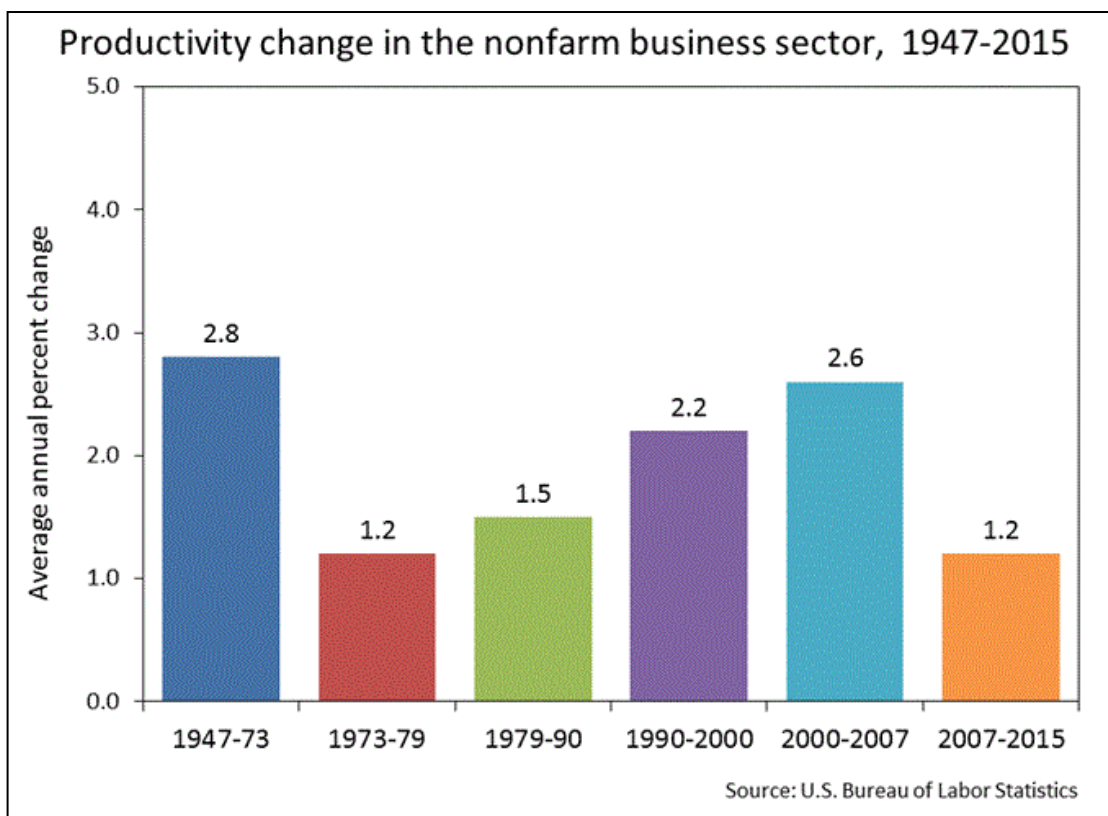


If approved, a car buyer could get up \$4,500 from the program to use toward the purchase of listed fuel efficient cars. It was deemed a roaring success by politicians. It only cost taxpayers \$3 billion. In 2014, two Texas A&M University economists produced a study of the program to determine its relative success.¹ They found that instead of stimulating auto industry sales, the program strikingly reduced overall revenues. There was an unnatural surge in the sale of Toyota Corollas, for example, but a later decline in the sale of more expensive cars consumers would have normally purchased. Toyota must have appreciated the stimulus program.

Productivity, Regulation, and America's Prosperity

Some argue that America's prosperity can be improved by imposing higher taxes on the more prosperous one percent and shifting the proceeds to the more deserving Middle Class. Unfortunately, getting long-term improvement through such trickle-over tactics just doesn't work out well. Taxing Peter to pay Paul always gets Paul's vote, but Peter has a way of avoiding the tax haircuts. We know that future GDP growth, wages, salaries, improved healthcare and even paying college tuition depend on improvements in labor productivity. If all of us hope to get more stuff, we will just have to produce more stuff. Let's face it. Someone has to pay for all this stuff. Right now, as shown by the accompanying Bureau of Labor Statistics chart, productivity growth looks pretty sorry.

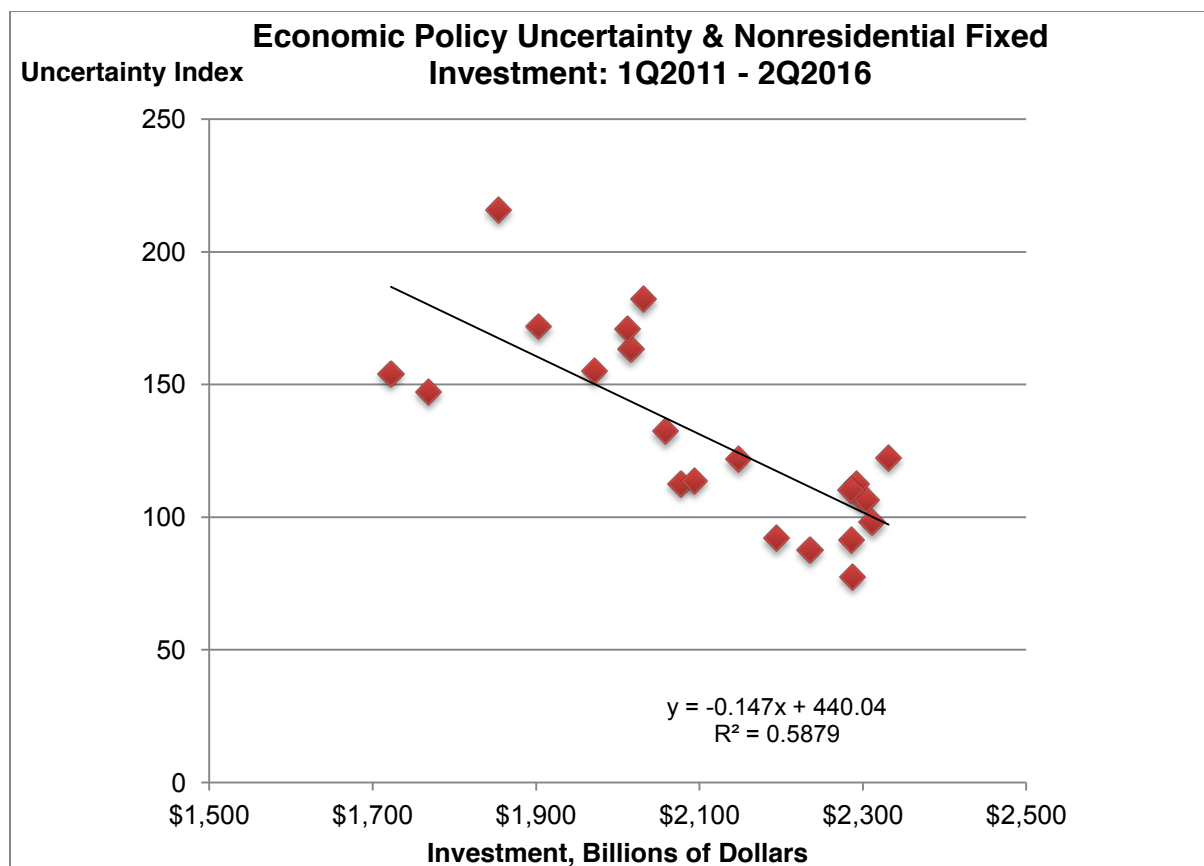
¹ <https://today.tamu.edu/2014/08/11/cash-for-clunkers-stimulus-program-backfired-say-texas-am-economists/>



Lots of moving parts lie behind these numbers. For example, there are the average age, experience, and educational attainment of U.S. workers. There are also improvements in the amount and kind of machinery and capital used by workers. Right now, even though interest rates are at rock bottom levels, business investment is lagging. Political uncertainty is one reason why that it so. Here's the logic: Tell me what the king will do, I will tell you if I am ready to place more of my purse in the game.

I show next the relationship between the Economic Policy Uncertainty Index, restated in quarterly terms, and U.S. investment in nonresidential fixed assets since 2011. The relationship weakens over longer periods. No, the mapping is not perfect, but the inverse relationship is strong. High uncertainty, low investment.

Right now? Policy uncertainty is riding high. It's crazy season, and those who want to be king are making a lot more promises than they can ever deliver.



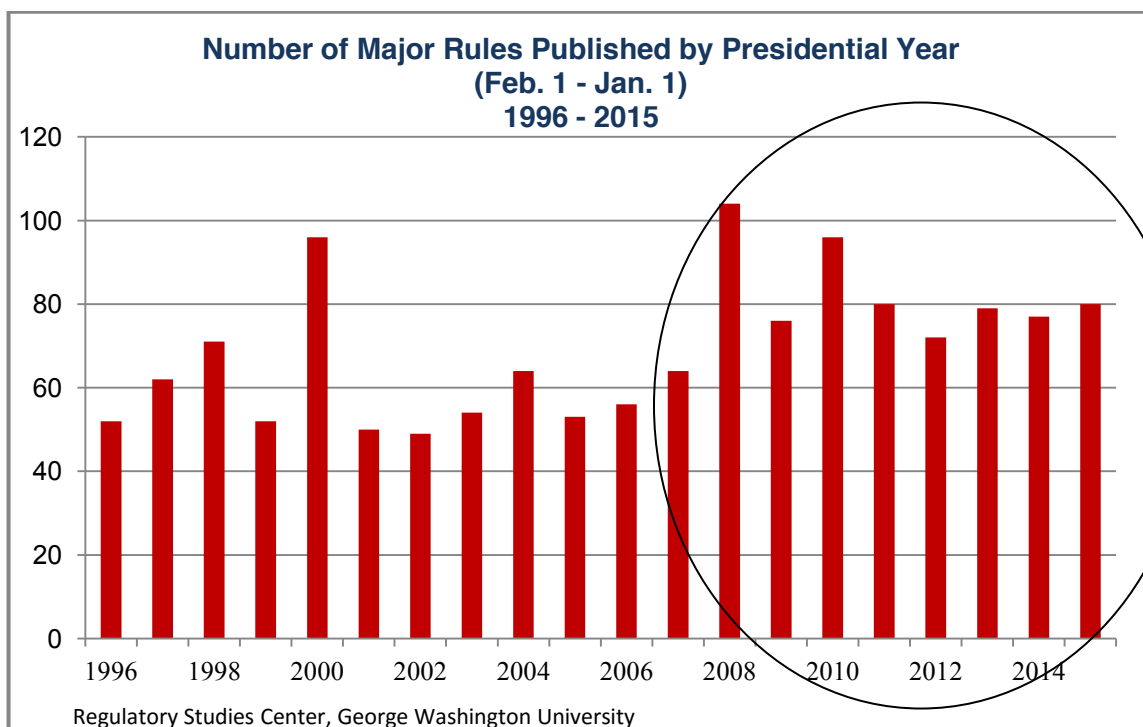
A lot that we produce is not counted

U.S. labor productivity is in the cellar for yet another reason, and a simple one at that. A lot of what is being produced today does not get counted when the Department of Commerce tallies its number. When U.S. workers produce more automobiles, days of healthcare service, and financial transactions, they are also turning out less carbon dioxide, discharging cleaner waste water, working in quieter factories, and making loans with a few million more pages of loan documentation. Put another way, America's Regulated Capitalism produces a lot of collateral output that does not always get recorded.

Some mandated changes do get counted. For example, the EPA's fuel economy standards set on August 16 for large trucks, school buses, and garbage trucks indicated the rules will cut more than 1 billion tons of carbon pollution from the atmosphere and will save \$170 billion in fuel costs.² When the newly evolved truck engines are developed, the Bureau of Labor Statistics will adjust the quality of truck engines produced to account for mandated changes in fuel economy. Labor productivity may rise with that part of regulatory changes. However, there are no productivity gains associated with reducing a billion tons of carbon emission from the air. The same is true of rules that restrict endangered species habitat and protect wetlands for water fowl. The rules restrict agricultural output, but there is no offsetting GDP gain.

² https://www.washingtonpost.com/news/energy-environment/wp/2016/08/16/white-house-sets-new-fuel-efficiency-standards-for-heavy-duty-trucks-vans-and-buses/?utm_term=.5d0c60e8500c

Federal regulatory agencies are required to give special attention to rules that impose costs on the economy of more than \$100 million annually. More costly rules, less productivity. I provide a chart on this for the years 1996 through 2015 produced by George Washington University's Center for Regulatory Studies. Note how the pace has quickened since 2008. In 2008, there were more than 100 major rules placed on the books. That's 100 times at least \$100 million in cost each year for as long as those rules are in effect. Yes, each one of those rules produces benefits, perhaps in the form of lower carbon emissions or more efficient irons and washing machines. But those benefits do not get translated into wages, salaries, healthcare benefits, and the ability to pay mortgages and student debts.



Do the benefits offset the costs? Yes, you can bet your boots they do, at least as reported by the agencies that promulgate the rules. But again, that doesn't mean labor productivity goes up. In 2015, the U.S. Office of Management and Budget reported that the *annual* benefits of rules published between 2004 and 2014, for which agencies provided benefit estimates, are in the aggregate \$261 and \$981 billion in 2010 dollars. OMB notes that the wide range reflects uncertainty in the estimates. I call attention to the high end estimate--\$981 billion in annual benefits from regulations, which is almost one trillion dollars. Let's put this in perspective. Second quarter 2016 GDP was just over \$16 trillion. The high end estimate, \$981 billion, is a bit more than 6% of GDP. As they say, that ain't chicken feed. It is not people food either.

Does inflation lie ahead and with it the next recession?

Aside from the gap between labor productivity and regulated production, there is another anomaly seen in current macroeconomic data. We have pale GDP growth, but tightening overall

labor markets, at least as measured by the conventional unemployment rate. Lower unemployment rates are of course good news for slow-recovery-weary job seekers. But as labor markets tighten and the number of individuals entering the labor force for the first time equals the number being hired, the economy reaches a point where, given the huge amount of available credit in the economy, tighter labor markets lead to higher wages and inflation.

The natural rate of unemployment is an estimate of just where that magic number lies. As indicated in the next Federal Reserve Bank of St. Louis chart, the July unemployment rate crossed the natural unemployment rate for the first time in this long post-recession expansion. The chart's observations show two other periods when markets tightened enough to cause the unemployment rate to be smaller than the natural rate. After a lag of almost a year, recessions followed in each of these cases.



Is there cause and effect here? Maybe, in a curious kind of way. The recessions that followed unusually tight labor markets were provided courtesy of the Federal Reserve Board. Interest rates were raised in an effort to slow a potentially over-heated economy. And recessions resulted.

In a June 2016 report, the Congressional Budget Office provided a rather detail snapshot on how Americans in different income groups are making out when it comes to taxes paid and subsidies received. The next chart, which was developed by American Enterprise Institute, gives the results. Notice first that CBO uses a comprehensive income measure. Their “market income,” is an amount that includes wages and salaries, capital gains, property, interest, and other income. They also show federal transfers received for all income groups; this includes

Medicare, Medicaid, Social Security and other federal program benefits. Notice that the average tax rate is negative across the first three quintiles, which include what some call Middle Class America. The rate becomes positive and increases across the remaining two quintiles.

Notice also that the average dollars received in transfers for every dollar paid in taxes falls significantly across the five quintile groups. Trickle-over economics doesn't work real well for people in the fourth and fifth quintile.

US Household Data by Income Quintile, 2013	Lowest Quintile	Second Quintile	Middle Quintile	Fourth Quintile	Highest Quintile
1. Average Market Income	\$15,800	\$31,300	\$53,000	\$88,700	\$253,000
2. Average Government Transfers	\$9,600	\$16,200	\$16,700	\$15,000	\$12,000
3. Market Income + Government Transfers (Before-Tax Income)	\$25,400	\$47,500	\$69,700	\$103,700	\$265,000
4. Average Federal Taxes Paid	\$800	\$4,000	\$8,900	\$17,600	\$69,700
5. Average Federal Tax Rates on Market Income + Transfers	3.1%	8.4%	12.8%	17.0%	26.3%
6. Federal Taxes Paid Minus Government Transfers Received	(\$8,800)	(\$12,200)	(\$7,800)	\$2,600	\$57,700
7. Average Net Federal Tax Rates After Government Transfers	-34.6%	-25.7%	-11.2%	2.5%	21.8%
8. Dollars Received in Transfers per Dollar Paid in Federal Taxes	\$12.00	\$4.05	\$1.88	\$0.85	\$0.17

Source: Congressional Budget Office, "The Distribution of Household Income and Federal Taxes," 2013

What lies ahead for 2016?

We have just four more months to go before year-end. GDP growth for the second quarter is hanging at 1.1%. I am expecting 1.4% for the year, which means that growth in the year's second half will be riding higher. Brexit and the related stronger dollar will continue to take some of the edge off export sales and this, at the margin, will slow the pace of growth for manufacturing. The latest readings on the manufacturing and services sectors show both parts of the economy are growing, with a strong pace of growth for new orders.³ At the same time, inflation at the commodity and consumer levels is still tame. Consumer-led growth should

³ The Purchasing Managers Association reported that "of the 18 manufacturing industries, 11 are reporting growth in July in the following order: Textile Mills; Printing & Related Support Activities; Miscellaneous Manufacturing; Wood Products; Furniture & Related Products; Chemical Products; Food, Beverage & Tobacco Products; Fabricated Metal Products; Nonmetallic Mineral Products; Petroleum & Coal Products; and Computer & Electronic Products. The seven industries reporting contraction in July — listed in order — are: Apparel, Leather & Allied Products; Electrical Equipment, Appliances & Components; Plastics & Rubber Products; Machinery; Primary Metals; Transportation Equipment; and Paper Products"

<https://www.instituteforsupplymanagement.org/ismreport/mfgrob.cfm>, August 1, 2016.

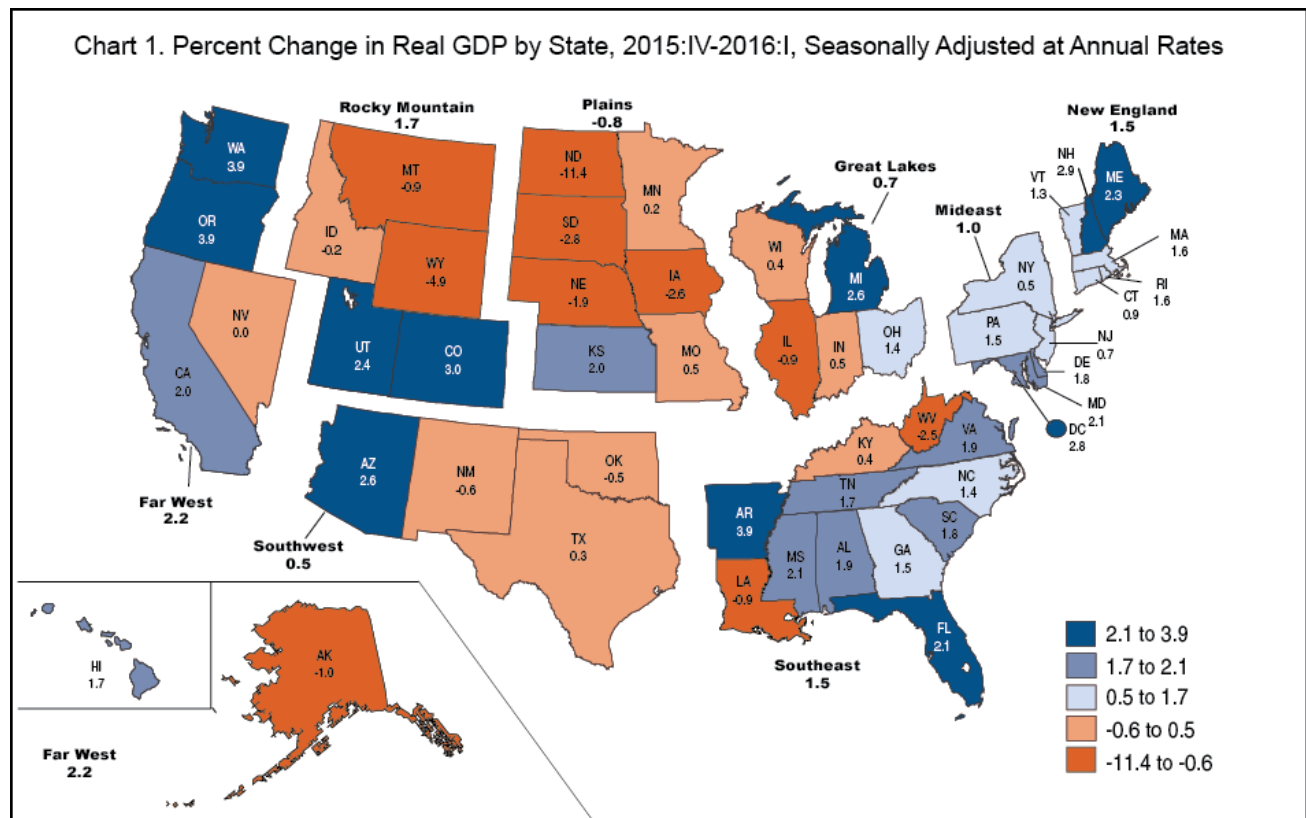
continue apace as we move into the year ahead. As to the rest of the world, it is interesting what a difference a couple of years can make. Not too long ago, news wires were hot with stories about the BRIC economies. Brazil, Russia, India, and China. Well Brazil and Russia are in recession and China has a heartbeat, but not nearly as strong as two years ago. Of the BRICs only India's economy is flourishing. We can include all of Europe in the economic sick bay, though Germany and Italy still are signally positive growth.

The U.S. economy is still in the slow lane, and will be there for the next 18 months or so.

The Geographic Imprint

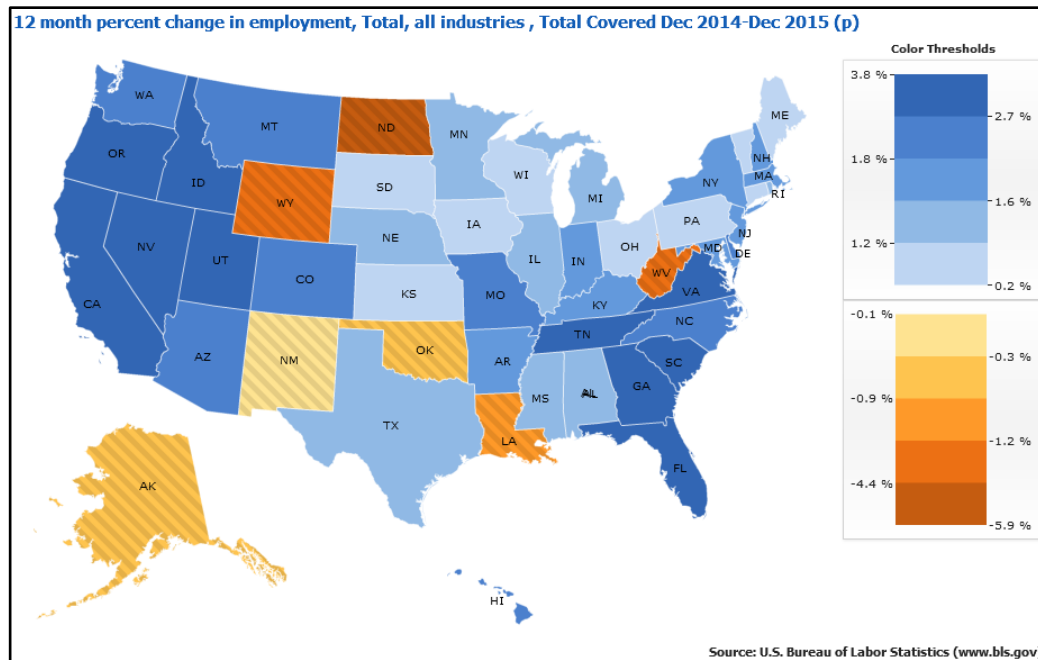
The dynamics of the U.S. economy are seen in the variation in GDP growth across time, the pace of post-recession recoveries, and the distribution of income generated by the churning of the Great American Bread Machine. Just how things happen across the states and regions gives yet another image of the American economy.

Do you ever wonder what someone is thinking when he or she says the U.S. economy is doing just fine? Just what zip code are they thinking about? Which state? Which region? America's is not a monolithic, homogeneous economy. The variation across states is large and deep. One way to see this is to examine short-term changes in real GDP by state. The next chart shows the percent change from 4Q2015 to 1Q2016. Notice that the Southeast has more blue—the positive color—than any other region, but the Pacific Northwest has the most dark blue—the strongest growth designation. Note also how the shale oil producing region is suffering. The data suggest it's time for states east of the Mississippi to have a good turn.



U.S. Bureau of Economic Analysis

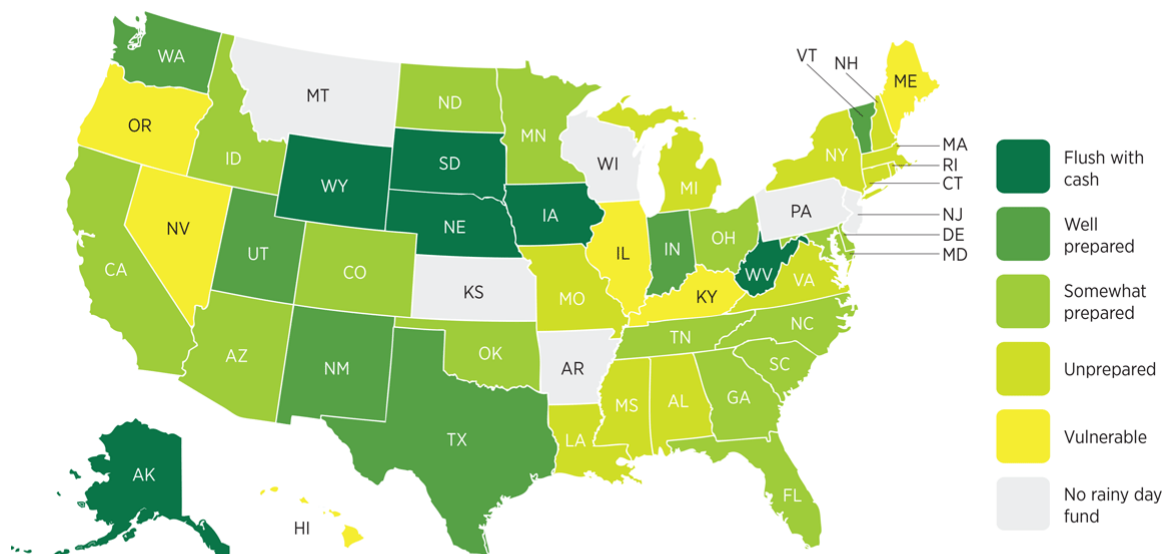
When we look at state growth in employment across the last 12 months, we see some similarities to short-term income growth. Notice again the Southeast and Far West are the stronger employment growth areas.



Weathering the next recession

Economist Erick Elder at George Mason University's Mercatus Center looked closely at state budgets, revenues and reserves and compared the data with bond rating agency recommendations for rainy day funds. After analyzing the data, Elder ranked the states on their ability to weather the next recession. The next map shows the result.

WEATHERING THE NEXT RECESSION: HOW PREPARED ARE THE 50 STATES?



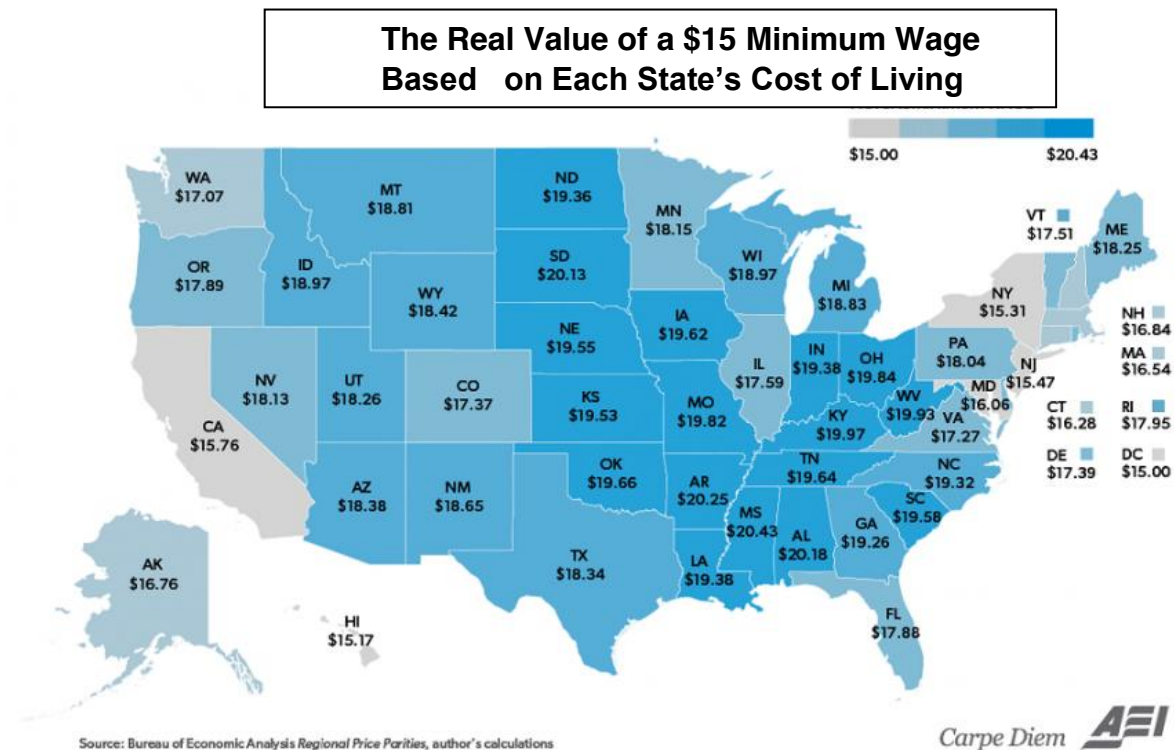
Source: Erick Elder, "Weathering the Next Recession: How Prepared Are the 50 States?" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, January 2016).

Note: A state's preparedness is determined by an average of two measurements of the percentage of potential economic contractions the state is able to weather using only the state's rainy day fund. The category "flush" indicates an average of 99.1 to 82.9; "well prepared," 79.9 to 67.0; "somewhat prepared," 65.1 to 50.2; "unprepared," 50.0 to 42.4; and "vulnerable," 36.6 to 17.6.

The geography of minimum wage

Presidential candidate Donald Trump has taken a stand on raising the federal minimum wage. He said: I would like to see an increase of some magnitude. But I'd rather leave it to the states. Let the states decide." On the other hand, Hillary Clinton, following Bernie Sanders lead has promoted a national \$15 minimum wage, a proposal that is naturally popular with workers in states where the number is much lower. Like all normal people, they want to earn more and hope to still be employed if the higher wages becomes reality. This is especially true in low-cost-of-living states. After all, it's what \$15 will buy that determines real income.

A recent map developed by American Enterprise Institute provides a useful comparison of cross-state effects of a federal \$15 per hour minimum wage. The AEI analysts adjusted the \$15 hourly rate by taking into account what \$100 will buy in each state, based on that states cost of living. On that basis, for example, a \$15 minimum wage in South Carolina will buy almost \$20 in lower cost S.C. goods and service. The adjusted differences are stark. Notice that California, a high cost of living state, has a real wage just a bit higher than \$15. In contrast, Mississippi's adjusted rate hits \$20.43 per hour. Obviously, organized labor loves the outcome. Low cost of living states lose their advantage when competing for new investment in services and manufacturing industries, and that makes life a bit more comfortable in high-cost states that hope to hold on to their footloose employers.



Shall we close the door to global trade?

For many, wages seem frozen in place. Job openings always seem to be two counties away from where an unemployed worker lives in an upside-down mortgaged house. And the town is still staggering from a recent factory closing blamed on low-cost foreign competition. It's hard for those caught in unemployment's wringer to be raving evangelists for new (or even old) free trade agreements.

Politicians seeking national office understandably respond to those they hope will help put them in office. When asked about free trade recently, Mrs. Clinton responded: "I will stop any trade deal that kills jobs or holds down wages, including the Trans-Pacific Partnership. I oppose it now, I'll oppose it after the election and I'll oppose it as president."⁴ On the same topic, candidate Donald Trump had this to say: "I am going to bring our jobs back. I pledge to never sign any trade agreement that hurts our workers."⁵ But while all this is understandable when political "crazy season" is running full bore, the overall picture across the states is a bit more complicated. Let's face it, the U.S. is a major global player. The world is integrated into our 50-state fabric. Consider the 2014 country-of-origin for goods imported by 50 states shown in the next map. China is the top source for 17 states. Do we really want to put tariffs on Chinese goods? Canada is the top sources in another 22 states. Do we really want to redo NAFTA?

⁴ (<http://www.washingtontimes.com/news/2016/aug/11/hillary-clinton-vows-to-kill-trans-pacific-partner/>).

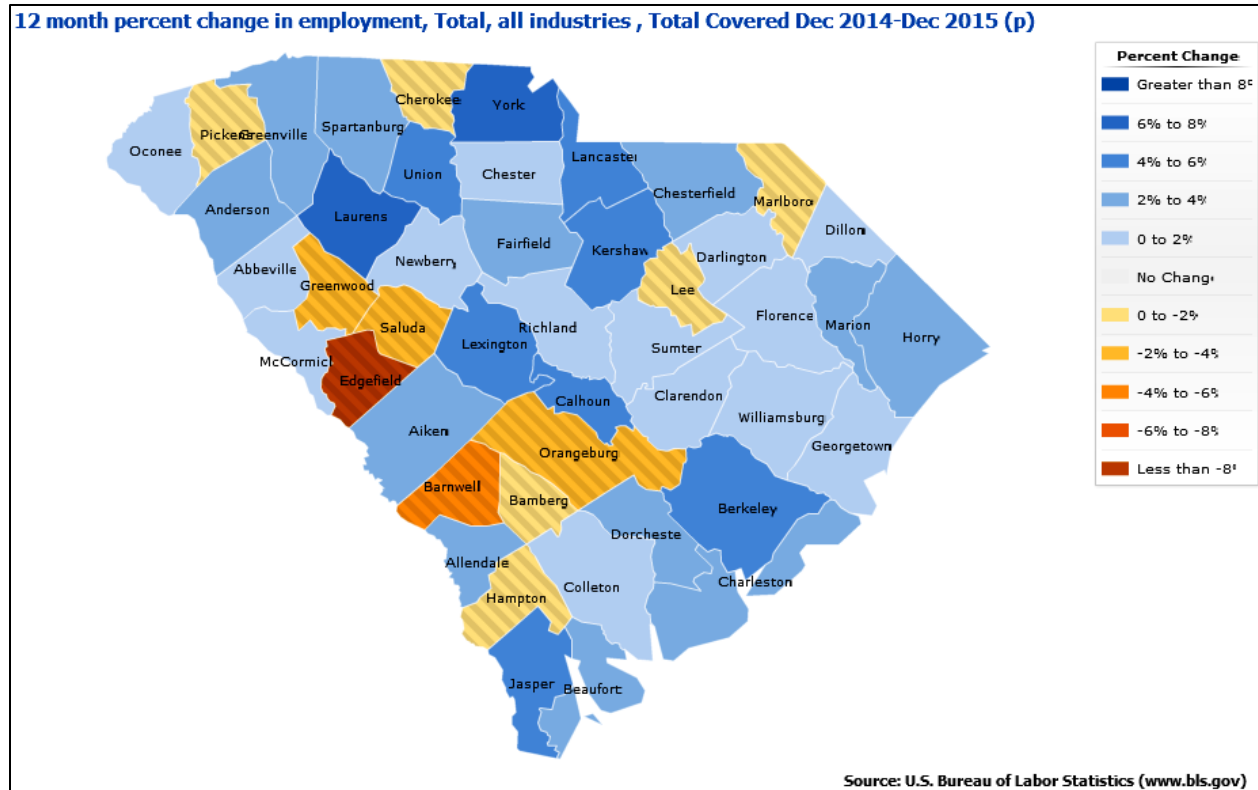
⁵ (<http://money.cnn.com/2016/07/22/news/economy/donald-trump-speech-trade-rnc/>).



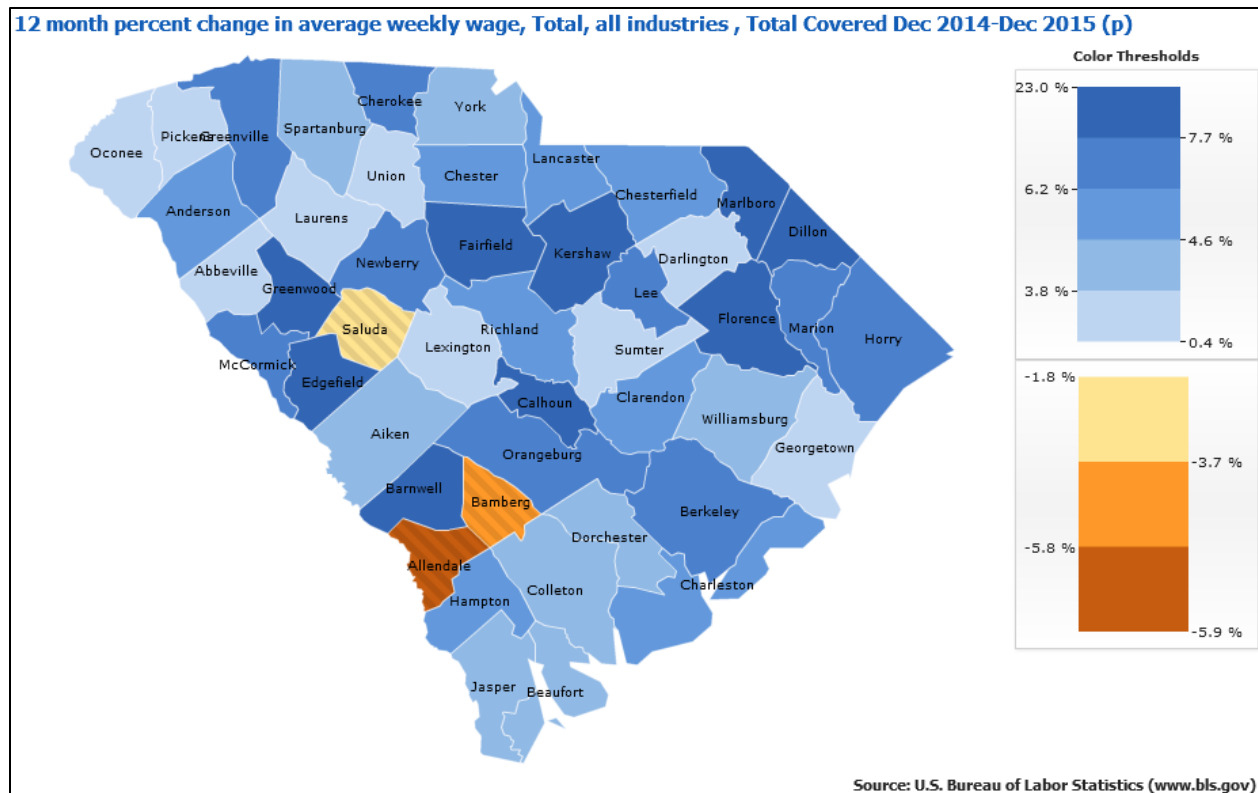
Now, consider the export side of the ledger, the top-country destinations for goods shipped from the 50 states. As the next map indicates, it's a NAFTA wonderland. In spite of pros and cons, one thing is certain: NAFTA and trade with China are woven into the 50-state economy.

As shown earlier in the Geographic Imprint section, South Carolina, located in the heart of the Southeast, is in the nation's second strongest growth region. West of the Mississippi is the stronger area, and the further west one travels, the better it gets. Through June 2016, the state has experienced strong total employment growth, and since January 2014, at a high and almost constant rate of increase. At the start of 2015, the state's large manufacturing sector began to experience slower growth, most likely because of the strong dollar and weaker export sales. Somewhat offsetting this, the growth of professional and business services (P&BS) has fallen and then accelerated. Right now, P&BS is the state's second strongest growth sector. Construction is the top dog..

While South Carolina is enjoying a strong season of economic growth, there is considerable variation in outcomes across the 46 counties. The accompanying chart gives employment growth for the period December 2014 through December 2015, which is definitely a short-term snapshot. Notice first that there are 11 counties registering negative growth. The high growth counties—6% or higher—include Berkeley, Calhoun, Jasper, Kershaw, Lancaster, Laurens, Lexington and York.



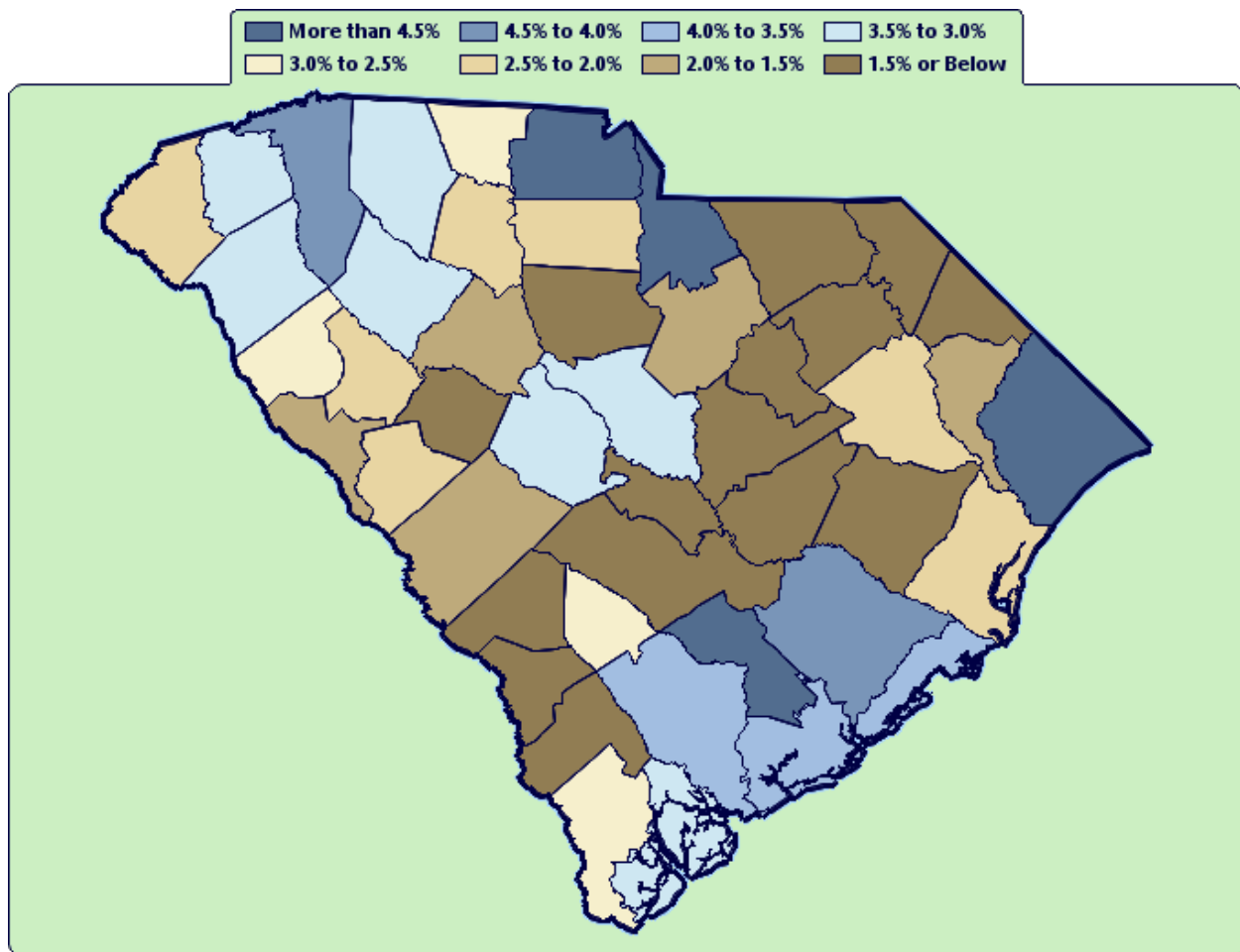
We see another short-run analysis in the next map. This shows what most people are interested in seeing, the increase in average wages for the year 2014. There is a lot of blue ink on this map, which means positive growth. Only three counties show a decline in average wages: Allendale, Bamberg, and Saluda.



But of course, income arrives in a large envelope. Along with wages, there is interest, rent, and various kinds of transfer payments. Using a different map format, we see another short-run assessment in the next map.⁶ This one shows growth in per capita personal income for 2014.

⁶ The next two maps are derived from https://south-carolina.reaproject.org/analysis/lsgl/by_indicator/total_personal_income/tools/

South Carolina Personal Income Growth, 2014



Source: South-Carolina.REAPProject.org
Data: Regional Income Division, BEA (11-19-2015)

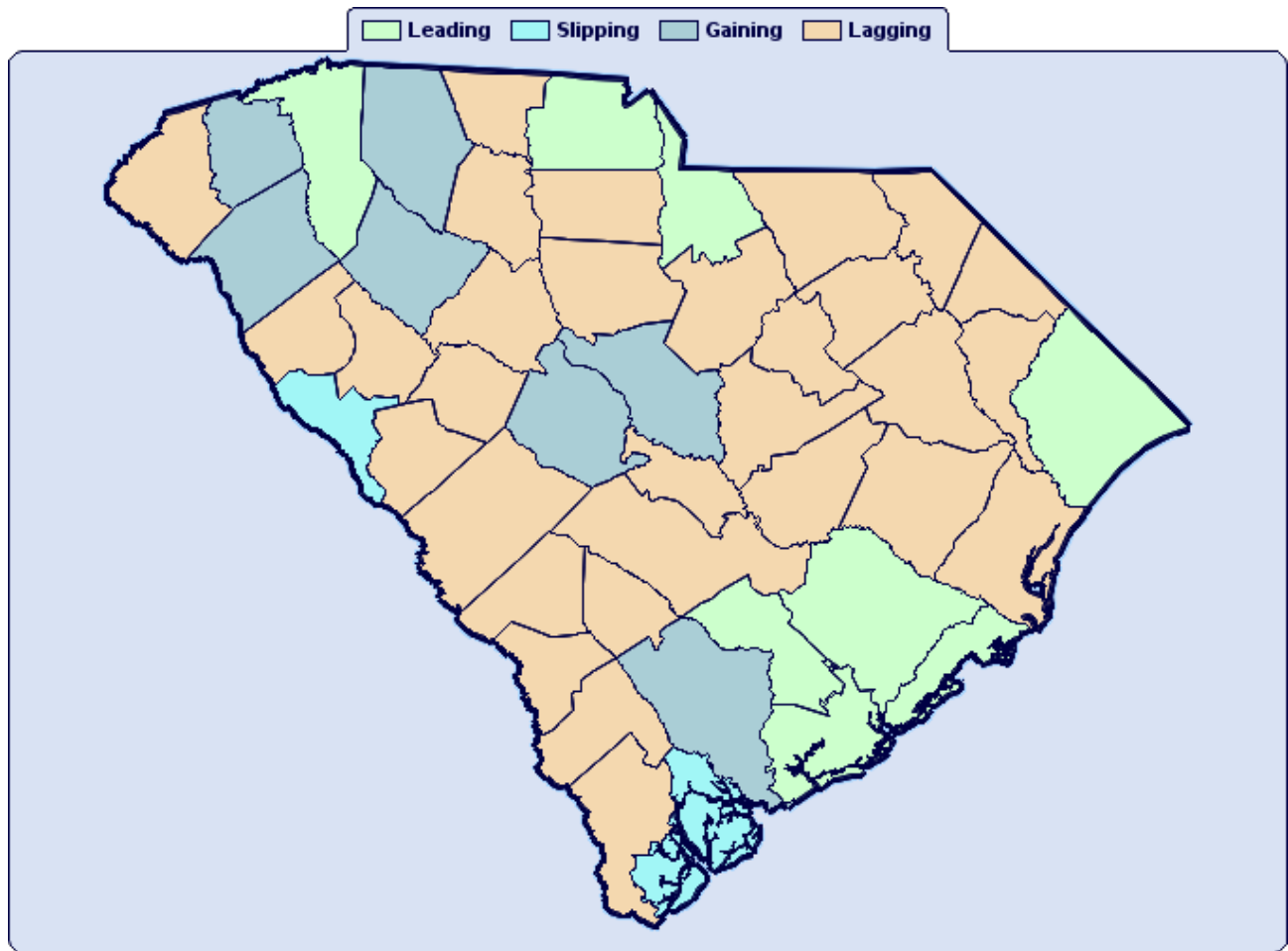
Once again, blue is the color of interest in this map. Here, the Beaufort-Colleton-Charleston-Berkeley-Dorchester, Richland-Lexington, Pickens-Anderson-Greenville-Spartanburg-Laurens, York-Lancaster and Horry are the standout regions. I note that these are by and large urbanized areas.

I next provide a more analytical map. This one compares short-run personal income growth (2014) with the longer-run growth (2010-2014) and sorts counties into four categories. Those that have higher than state average growth for both the short and longer periods are identified as Leading. Counties that have higher than state average growth for 2010-2014, but lower growth in 2014 are called Slipping. Those that are below average for the longer period but above average for 2014 are called Gaining. And those that are below average for both the short and longer periods are lagging.

As indicated, there are seven Leading counties. These are Charleston-Berkeley-Dorchester, Horry, Lancaster-York, and Greenville. Then, there seven gaining counties: Colleton, Lexington, Richland, Anderson, Pickens, Spartanburg, and Laurens. We might think of these 14

counties as forming the state's growth engines. The remaining counties are either slipping or lagging the state's average income growth rates.

Real Total Personal Income Growth by County vs. Statewide Average: 2005-2014 and 2014



Source: South-Carolina.REAProject.org
Data: Regional Income Division, BEA (11-19-2015)

What are the prospects for the rest of 2016? South Carolina should continue to enjoy strong growth in its leading regions, and population growth should respond accordingly.

ECONOMIC POSSIBILITIES FOR OUR GRANDCHILDREN

Writing at the outset of the Great Depression, in 1930, John Maynard Keynes took a longer view of the situation. He wrote down his thoughts in *Economic Possibilities for Our Grandchildren* (*Essays in Persuasion*, New York: W.W. Norton, 358-373).⁷ Keynes was convinced that in spite of its problems a market economy would outperform any other system when it came to producing food, clothing, shelter, transportation, and the other stuff of life that people wanted. But he believed that by the year 2030 people would be satisfied; they would have more than enough stuff to go around.

He expressed the wish that his generation's grandchildren would no longer be driven by personal gain. He hoped a new form of state capitalism would focus attention on the provision of things that markets did not provide so very well. Keynes predicted an expansion of government support of the arts, the humanities, and enhancement of the human condition. He put it this way:

“Thus for the first time since his creation man will be faced with his real, his permanent problem—how to use his freedom from pressing economic cares, how to occupy the leisure, which science and compound interest will have won for him, to live wisely and agreeably and well.”

We have 14 years to go to reach 2030. How are we doing? Will we reach Mr. Keynes's promised land?

At the time Keynes wrote, in 1930, U.S. per capita GDP stood at \$11,266 expressed in 2015 dollars.⁸ It was down 10% from 1929, the roaring year of the November crash. I think we would all agree the 1930 Middle Class was not doing real well. Do you know anyone today who is getting by cheerfully on \$12,000 a year? By comparison, President Hoover was paid \$75,000 that year, the equivalent of more than a million in today's money. He was doing great! (This year, President Obama will earn only \$400,000, but there are a lot of fringe benefits. Shouldn't he get at least a cost-of-living increase?) By the year 2015, just 85 years after Keynes penned his essay, world per capita GDP stood at \$10,000, an amount almost equal to the 1930 U.S. average. Let's face it. A lot of stuff has been stacking up in tents, closets and storage units.

Keynes thought that U.S. real per GDP would rise four- to eight-fold from 1930 to 2030. In 2015, the number was \$51,486, a bit less than a five-fold increase. He made a darn good forecast!

Keynes might have thought that this would surely be enough to provide all the stuff desired for life, that we Americans would have long ago embraced his hope and lifted our eyes to higher ground. But if he were around today, I think he might be disappointed. The conversation is still very much about wages, jobs, income, paying off debt, getting more healthcare, and picking up a larger piece of American pie.

⁷The essay is available on-line at <http://www.econ.yale.edu/smith/econ116a/keynes1.pdf>.

⁸<http://socialdemocracy21stcentury.blogspot.com/2012/09/us-real-per-capita-gdp-from-18702001.html>, which reported 1930 per capita GDP in 1990 dollars at \$6,213. When adjusted for the inflation, this converts to \$11,266 in 2015.

There is always another necessity to yearn for. Or so it seems. Pokemon Go, anyone?